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SUBJECT: SLOVAK ECONOMY GROWING AT RECORD PACE

¶1. SUMMARY: In the last quarter of 2005, the Slovak economy reached an all time record for economic growth of 7.6 percent, the fastest rate among the four biggest economies that joined the EU on May 1, 2004. A high volume of investments and fast-growing household consumption were the key growth engines, while external factors played a negative role. Unemployment over the last three months of 2005 dropped to the lowest rate since the first quarter of 1999 and wages rose at one of the highest rates in the whole EU, exceeding productivity growth. Economic analysts expect further interest rate hikes in the coming months. END SUMMARY.

¶2. Slovakia's GDP rose at a historic annual rate of 7.6 percent in real terms (9.9 percent in nominal terms) during the last quarter of 2005, to SKK 384.1 billion (USD 12.4 billion). For the full year 2005, the Slovak economy accelerated by 6.0 percent year-on-year, the highest rate in 10 years, to SKK 1,439.8 billion (USD 46.4 billion), after a 5.5 percent growth in 2004. The private sector generated 90.6 percent of GDP last year. Slovakia's growth matched the Czech Republic's economic performance, while it was ahead of Poland with 3.2 percent and Hungary with 4.1 percent rates for 2005.

STRUCTURE OF GROWTH REMAINS THE SAME

¶3. The main driver of the economy was domestic demand, led primarily by investments. The gross investment showed an extraordinary 33.5 percent year-on-year increase in the fourth quarter, contributing 6.6 percentage points to the growth rate. Significant components of this high growth rate were changes in stocks and inventories. (NOTE: Some retailers built up their stocks of cigarettes due to the increase in excise tax of tobacco effective January 1, 2006). Fixed investments alone grew 15.1 percent, providing 3.9 percentage points to the overall rate. Household consumption, the second strongest growth engine, slowed down to an annual 5.9 percent rise, from 6.2 percent in the third quarter, extending its growth to the eighth consecutive quarter after two years of stagnation in 2002 and 2003. Government spending rose 3.8 percent in the reported period, accelerating from 0.9 percent in the preceding quarter.

¶4. External demand played a negative role in the last three months of 2005. Net exports (exports minus imports) knocked off 3 percentage points from the growth rate, with imports rising 17.7 percent and exports 15.0 percent year-on-year during the last quarter. The trade balance deteriorated primarily in December, which itself produced 33.4 percent of the full year trade deficit. The massive growth in

investment indicated that a significant portion of imports were technologies for the two car plants under construction. (NOTE: French PSA Peugeot is scheduled to kick off its production in May, while South Korean Kia should start in November. Both plan their annual output for 300,000 cars at full capacity). Rising import prices of commodities also contributed to the overall foreign account deterioration as Slovakia is almost fully dependent on Russia for natural gas and oil.

UNEMPLOYMENT AT A SIX-YEAR LOW

¶5. According to the Statistical Office (using data based on random telephone surveys), Slovakia's unemployment rate dropped to 15.3 percent in the fourth quarter of 2005, the lowest rate since the first quarter of 1999. Compared to the same period in 2004, the number of unemployed people in 4Q05 declined 10.4 percent to 407,600. For the whole of 2005, the unemployment rate fell by 1.9 percentage points to 16.2 percent, while the number of unemployed people was down by 11.1 percent to 427,500 (This data is taken as an average for the full year and is therefore higher than the fourth quarter numbers). Statistics provided by the Ministry of Labor, which are more in line with the U.S. methodology focusing on those actively seeking employment, indicated that unemployment dropped from 15.6 percent in 2003 to 11.36 percent in December 2005. The strong economic growth also resulted in a 2.1 percent annual rise in employment for
¶2005. At the end of the year, 2.26 million people in Slovakia had jobs, a rise of 2.5 percent or 54,900 on the year.

WAGES OUTPERFORMED PRODUCTIVITY

¶6. Average nominal monthly wages grew by 9.2 percent year-on-year in 2005, to SKK 17,274 (USD 560), or 8.4 percent in the last quarter, to SKK 19,466 (USD 628). For the same period, real wages rose 6.3 percent and 4.7 percent, respectively. In 2004, real wages increased 2.5 percent on an annualized base. In comparison, the labor productivity slowed down to 3.7 percent in 2005, from 5.2 percent in the previous year. The central bank noted that if such a strong relative wage increase over productivity growth as seen in 2005 was repeated this year the economy would face serious inflationary risks.

¶7. COMMENT: The central bank cited robust economic growth based on strong growth of investments and household consumption as one of the principal reasons behind a 50 basis point interest rate hike in February, 2006. Despite the slow down in household spending during the last months of 2005, the GDP structure in combination with wages (rising faster than productivity) and retail sales data still imply potential demand-led pressures on consumer prices. This suggests that the central bank may incline to further monetary tightening. Strong household consumption assisted by increased employment, rising real incomes and better access to credit confirmed the fast growth in improving living standards, which is theoretically good news for a governing coalition facing early parliamentary elections in June. The positive effects are not being felt equally throughout the country, however, and may not be enough to bring about a third-term for a Dzurinda-led center-right coalition. The upcoming start of production at the two car plants will provide strong one-time impetus for the economy and could accelerate its growth to over 7 percent this year.

VALLEE